

Societal Impact Highlights



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Case study: Determinants and economic consequences of non-GAAP financial reporting in Europe

Summary

The financial information disclosed by a firm is critical in supporting investment decisions, as it provides information that is useful to estimate future expected performance. GAAP (Generally Accepted Accounting Principles) earnings are included in the European firms' financial statements and are subject to auditing and other controls. Non-GAAP earnings refer to alternative measures of financial performance, created entirely voluntarily by managers, disclosed in annual announcements, and are not audited nor regulated in Europe.

The research shows that managers of European firms disclose non-GAAP measures to positively influence investors' perceptions about the firm performance and to meet earnings targets such as analysts' forecasts of earnings. The study also shows that managers' behaviour regarding disclosure of non-GAAP measures varies across countries. The results of the study inform investors, analysts, regulators and the general public that managers may use voluntary disclosure to strategically inflate the firm performance. Investors and regulators should be aware that strategic use of non-GAAP reporting increases in countries where laws and regulations are less protective of investors' rights and there are less sophisticated investors. The results were particularly important for the European Securities and Markets Authority (ESMA) who is currently issuing guidelines to discipline managers' non-GAAP disclosure. Academic evidence about non-GAAP reporting is considered by the ESMA when issuing these guidelines.

In light of these research results ESMA can consider whether to adopt or not more stringent guidelines, and whether the guidelines should vary across countries.

Underpinning research

Helena Isidro and collaborators (Ana Marques from Nova School of Business and Economics) conducted extensive research on non-GAAP reporting by large European firms. Using a time period of eight years the authors documented several important non-GAAP practices, showing that the majority of European large firms report non-GAAP measures in their annual earnings announcements. They also show that in most cases the non-GAAP measures are higher than GAAP measures which indicates that managers use non-GAAP numbers to portray better firm performance. Whether managers do it to show the correct recurrent performance, or to strategically manager investors' perceptions was a key research question.

A first study (Isidro and Marques, 2015) shows empirically that managers' report more non-GAAP information in countries which are legally and economically more developed. In developed countries managers use less mandated information to inflate performance (e.g. less earnings management) due to more stringent scrutiny over financial statements by auditors, analysts, regulators, and the general public. Consequently they make more use of voluntary unregulated information to pass an image of high performance. The study also shows that effective legal systems, stronger investor protection rules, more developed markets, and better communication channels mitigate managers' aggressive use of non-GAAP numbers to beat earnings targets. These results suggest that country-level institutional quality not only promote the role of public information in reducing information asymmetries, but also help to curb managerial opportunism which can mislead investors.

A second analysis (Isidro and Marques, 2013) develops an empirical model that aims to investigate whether the corporate governance of the firm affects management of non-GAAP reporting practices. The authors find that compensation contracts linked to firm's market performance are associated with a higher probability of disclosing opportunistic non-GAAP figures in the earnings announcement's press releases. They also find that an efficient governance structure of the board of directors can help restrain most of these discretionary disclosure decisions regarding non-GAAP reporting.

The third study (Isidro et al, 2015) shows that managers use language techniques to emphasize their non-GAAP measures, such as increasing the positive tone of communication, emphasizing certain non-GAAP numbers by placing them at the top of the press release, or including forward

looking measures that portray rosy future performance. The authors develop tests to measure the market reaction to disclosure of non-GAAP numbers supplemented with exceedingly positive language and find that investors are able to see through managers' intentions and ignore non-GAAP information that is accompanied by high impression management.

References to the research

- Isidro, H. & A. Marques (2015). The Role of Institutional and Economic Factors in the Strategic Use of Non-GAAP Disclosures to Beat Earnings Benchmarks *European Accounting Review*, Vol. 24, No. 1, 95–128, <http://dx.doi.org/10.1080/09638180.2014.894928>
- Isidro, H. & A. Marques (2013). The Effects of Compensation and Board Quality on Non-GAAP Disclosures in Europe. *The International Journal of Accounting* 48 (2013) 289–317, <http://dx.doi.org/10.1016/j.intacc.2013.07.004>
- Isidro, H., E. Guillaumon Saorin & A. Marques (2015). Impression Management and Non-GAAP Reporting in Earnings Announcements. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1984056

Details of the impact

The research on non-GAAP reporting in Europe shows that managers extensively disclose non-GAAP performance measures when they communicate their annual earnings. It also shows that the firm governance structure and the country's institutional and economics conditions are important determinants of how managers use non-GAAP disclosures.

Beneficiaries and impact:

The main interested beneficiaries are investors and creditors who use information about earnings (both GAAP and non-GAAP) in their financing decisions. Investors now use non-GAAP information extensively to form their investment decisions, and provide funds to the firm. For example, studies demonstrate that investors react more non-GAAP information than GAAP information.

Second group of beneficiaries are regulators. Capital markets agencies and economic agencies ensure that financial information is transparent and faithfully represent the firm's performance, and are also interested in how managers' report alternative information about performance. In the US market regulators (Securities and Exchange Commission) has issued stringent rules on how firms should disclose non-GAAP information. In Europe the ESMA has not issued rules but

has just introduced detailed guidelines on non-GAAP reporting. Given that non-GAAP information can be used opportunistically by firms, the regulators are most concerned about the matter and thus want to ensure the non-GAAP information is sufficiently clear particularly for less sophisticated investors and creditors.

Third important group of beneficiaries of the research results are financial analysts who construct projects about the firm's future cash flows. Financial analysts companies such as IBES now produce projects of firms earnings based both on GAAP and non-GAAP information.

All three underpinning studies have relevant policy implications. Regulators such as the European Stock Markets Authority can take into consideration that investors seem to perceive attempts to positively inflate firm performance, particularly in sophisticated capital markets. Such evidence suggests that European regulators do not need to impose strict measures to control non-GAAP reporting practices as US market authorities did. Creating and enforcing non-GAAP strict rules is costly, therefore a possible alternative is to rely on market mechanisms and governance quality to discipline non-GAAP information.

The studies have also created awareness among investors, creditors, and other stakeholders about alternative information (quantitative and qualitative) that managers disclose. The studies highlight what is non-GAAP information and how managers use it. It highlights that non-GAAP information is useful to investors and creditors but can be used opportunistically by managers. This information can be taken in consideration for example by creditors in deciding their cost of borrowing.

Sources to corroborate the impact

- ESMA report on Alternative Performance Measures (2015).
http://www.esma.europa.eu/system/files/2015-esma-1057_final_report_on_guidelines_on_alternative_performance_measures.pdf

- Dissemination of results at conferences through informal contact with beneficiaries:

Presentation and discussion of empirical results, European Accounting Association Annual Conference (2011 and 2012)

Presentation and discussion of empirical results, American Accounting Association Annual Conference (2008, 2011 and 2014)

Presentation and discussion of empirical results, VII Workshop on Empirical Research in Financial Accounting (2009)

- Widespread information about non-GAAP reporting to the general public interested in financial information: <https://www.youtube.com/watch?v=U90IUFE CFM8>
- Research results are discussed in Master and MBA classes (Msc Accounting at ISCTE-IUL – 2010-2013, Executive masters in Corporate Reporting at ISCTE-IUL-2015) <http://indeg.iscte-iul.pt/programa/executive-master-corporate-reporting>